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Supreme Court of the United States

OCTOBER TERM, 1942.

No. 182

O'BRYAN BROTHERS, PETITIONER,

VS.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF.

CECIL SIMS,
Attorney for Petitioner.

BASS, BERRY & SIMS,
Of Counsel.

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O'BRYAN BROTHERS, PETITIONER,

VS.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

May It Please the Court:

The petitioner, O'Bryan Brothers, a corporation, respectfully shows to this Honorable Court:

SUMMARY STATEMENT OF THE MATTER INVOLVED.

The petitioner, O'Bryan Brothers, a corporation engaged in the manufacture of work clothing in Nashville, Tennessee, filed its petition against the Commissioner of Internal Revenue in the United States Circuit Court of Appeals for the Sixth Circuit (No. 8950) seeking to have

that court review and set aside a deficiency assessment found by the Board of Tax Appeals to be due in the income tax and excess profits tax of petitioner for the calendar year 1933 in the respective amounts of $10,476.35 and $684.58.

There was no dispute with respect to essential facts as the evidence before the Board of Tax Appeals consisted entirely of the testimony of T. P. Kennedy, Jr., President of petitioner corporation, and the exhibits. These undisputed facts may be summarized as follows:

Petitioner had heavy losses in 1930 and 1931, and towards the end of 1931 it owed the American National Bank of Nashville, Tennessee, the sum of $145,000. The bank caused an audit to be made, which disclosed that T. P. Kennedy, Sr., individually owed three accounts to the corporation which had been running many years, aggregating approximately $208,000 as of December 31, 1930. The bank demanded that T. P. Kennedy, Sr., execute his note for the amount of his indebtedness to the corporation and secure the same by pledging all of his holdings in petitioner's common stock (1,308 shares out of a total of 1,500 shares outstanding) to the corporation as collateral, and by executing a deed of trust on his residence. This was done and Kennedy's note and collateral securing the same were transmitted by the corporation to the bank as security for the corporation's indebtedness to the bank (R. 61-65).

During the early part of 1932 the corporation continued to suffer heavy losses and T. P. Kennedy, Sr., who was then President, became highly nervous and remained at home and was not able to get out. The American National Bank, as the largest creditor, then took charge of the corporation's business and operated it under the supervision of George J. Hearn, a Vice President of the bank, and his assistant, J. C. Schutt. T. P. Kennedy, Sr., was removed from supervision over the affairs of the corporation and placed on the road as a salesman at a greatly reduced salary, and the entire direction of the business was in the bank (R. 65-66).

In order to keep the company operating in 1932 the bank subordinated its entire indebtedness and guaranteed the corporation's commercial accounts. A further loss was incurred for the calendar year 1932.

After T. P. Kennedy, Sr., was removed from office, his son, a young man thirty years of age who owned no common stock in the corporation, was made nominal President of the corporation. Shortly thereafter, in the spring of 1933, President Roosevelt closed all of the banks as a result of the severe business depression (R. 66).

In June, 1933, the American National Bank was unwilling to continue its financial support of the corporation unless T. P. Kennedy, Jr., would agree to a permanent connection with the corporation and then only provided his position was made secure and permanent by a transfer to him of fifty-one percent of the common stock, representing control, out of the collateral which T. P. Kennedy, Sr., had pledged to secure his indebtedness. The corporation was fighting desperately to keep itself afloat, and it had no choice except to comply with the bank's demand. The alternative was bankruptcy and dissolution. Under this economic compulsion, the corporation released 751 shares of the common stock which it held as collateral and T. P. Kennedy, Sr., was required to transfer it to his son, who thereupon assumed the permanent control of the corporation's affairs (R. 68).

T. P. Kennedy, Sr., individually was insolvent. He owed a total of $238,000, and he had no other assets except those pledged to secure his indebtedness to the corporation. He was at an advanced age of life, had lost control of the corporation, was in bad health and had been reduced to the position of salesman at a small salary. The interest on his indebtedness to the corporation was more than $1,000 per month, and this interest alone was more than three times his salary (R. 65, 69, 70, 71).

The petitioner's indebtedness against T. P. Kennedy, Sr., under these circumstances, had no value other than the value of the collateral. The highest ap-

praised value of the homeplace was $35,000. The proof shows that the common stock, at the time of the surrender, had an actual value of between $65 and $70 a share. The 557 shares of common stock which remained pledged to secure the indebtedness, at this valuation, were worth approximately $70,000, so that the total remaining collateral was worth approximately $105,000. The corporation therefore valued its collateral at this amount and deducted the value from the indebtedness and charged off the difference, which was a loss of approximately $138,000 (R. 69-70).

The Board of Tax Appeals disallowed the deduction upon the ground that petitioner *voluntarily* relinquished the collateral consisting of 751 shares of its common stock. It also found that the value of the common stock was $150 per share.

The Circuit Court of Appeals affirmed the decision. It held in substance that the valuation of $150 per share placed on the stock by the Board of Tax Appeals was supported by substantial evidence and that petitioner *voluntarily* surrendered collateral which otherwise would have made its debt good, and the resulting loss occurred by reason of this *voluntary* act on the part of petitioner.

The Circuit Court of Appeals disregarded and made no mention of the *undisputed evidence* which showed that petitioner released the collateral upon the demand of the bank, under the threat of bankruptcy and dissolution, which amounted to economic compulsion and rendered the release involuntary, as the only alternative was dissolution and the consequent loss of the entire debt.

REASONS RELIED UPON FOR THE ISSUANCE OF THE WRIT.

1. The decision of the Circuit Court of Appeals for the Sixth Circuit in the instant case, in holding that the surrender of stock under economic compulsion was a volun-

tary act, is directly in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in *Commissioner of Internal Revenue* v. *Wright,* 47 F. 2d 871, and is also in direct conflict with the decision of the Circuit Court of Appeals for the Third Circuit in *Commissioner of Internal Revenue* v. *Burdick,* 59 F. 2d 395. It also conflicts with the previous decision of the Circuit Court of Appeals for the Sixth Circuit in *Deeds* v. *Commissioner of Internal Revenue,* 47 F. 2d 695.

2. The decision of the Circuit Court of Appeals for the Sixth Circuit in the instant case involves an important question of Federal law which has not been, but should be, settled by this Court.

Your petitioner annexes hereto and presents herewith as a part of this petition a certified copy of the entire record in this cause in the Circuit Court of Appeals for the Sixth Circuit, specification of error, and brief and argument, giving in more amplified form the reasons why the decision and judgment of the Circuit Court of Appeals for the Sixth Circuit was erroneous and should be reversed, and respectfully asks that the certified copy of the record, specification of error, brief and argument be considered in connection with and as a part of this petition for the purpose of testing the correctness of the ruling of the Circuit Court of Appeals for the Sixth Circuit.

PRAYER FOR WRIT.

Wherefore your petitioner, O'Bryan Brothers, a corporation, respectfully prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the Circuit Court of Appeals for the Sixth Circuit, commanding that court to certify and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record and all proceedings in the case cited on its docket

as No. 8950, styled O'Bryan Brothers, Petitioner, v. Commissioner of Internal Revenue, Respondent, and that said judgment of the said United States Circuit Court of Appeals for the Sixth Circuit may be reversed by this Honorable Court, and that your petitioner may have all other and further relief in the premises as the Honorable Court may deem meet and just; and your petitioner will ever pray.

O'BRYAN BROTHERS,
By CECIL SIMS,
Attorney for Petitioner.

BASS, BERRY & SIMS,
Of Counsel.

Supreme Court of the United States

OCTOBER TERM, 1942.

No. .....

O'BRYAN BROTHERS, PETITIONER,

VS.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

I.

JURISDICTION.

The opinion of the United States Circuit Court of Appeals for the Sixth Circuit is printed on pages.....to..... of the record and has not yet been officially reported. The opinion and judgment of the United States Circuit Court of Appeals were handed down and entered on April 16, 1942.

II.

STATEMENT OF THE CASE.

There are two questions involved in the case:

1. Was the surrender of the collateral voluntary or involuntary?

2. What was the value of the common stock per share at the time of the surrender?

It is petitioner's insistence that the collateral was not voluntarily surrendered but was released involuntarily under economic compulsion and that petitioner consented to the release of the collateral upon the demand of the bank in order to prevent bankruptcy and dissolution.

It may be assumed in considering the first question that the finding by the Board of Tax Appeals that the common stock had a value of $150 per share was supported by substantial evidence. Assuming this valuation, the collateral retained by the petitioner after the surrender of the 751 shares of common stock had a total value of $118,550 (557 shares at $150 per share plus $35,000, the value of the real estate), thereby resulting in an ascertained loss of $90,017.20 which, under the Board's findings, would completely eliminate all net profit for the year 1933 so that no deficiency tax could be assessed.

If this question is resolved in favor of petitioner's contention, the second question will become immaterial.

III.

SPECIFICATION OF ERROR.

1. The United States Circuit Court of Appeals for the Sixth Circuit erred in holding that O'Bryan Brothers voluntarily released 751 shares of its common stock held as collateral to the indebtedness and that the partial loss

resulting therefrom was caused by its own voluntary act. The undisputed proof shows that said release was made under economic compulsion, with no alternative other than bankruptcy and dissolution, and hence such release was involuntary.

2. There is no substantial evidence to support the findings of either the Board of Tax Appeals or the Circuit Court of Appeals that the stock in question was reasonably worth $150 per share.

IV.

ARGUMENT.

The underlying principle upon which the Circuit Court of Appeals disallowed the deduction against Kennedy, Sr., was that the debt became partially worthless because of the petitioner's own voluntary surrender of a portion of its collateral.

It is well settled that a taxpayer cannot claim a loss resulting from its own forgiveness of a debt or from its voluntary surrender of collateral.

But it is equally well settled that the cancellation of the debt or the surrender of collateral through economic compulsion in order to escape greater losses through threatened financial ruin is not a voluntary cancellation of indebtedness or surrender of collateral. The courts have taken a realistic view of such a factual situation as the one presented by the undisputed evidence in the present case and have consistently held that one who is forced to give up security in a desperate effort to keep a business going does not commit a voluntary act contributing to its loss but acts involuntarily with no reasonable choice and any loss ensuing is deductible provided the act was taken in good faith.

In *Commissioner of Internal Revenue* v. *Wright*, 47 F. 2d 871, a corporation became involved in financial dif-

ficulties and was largely indebted to a bank. As in the present case, the bank refused to continue to carry the indebtedness and threatened bankruptcy proceedings unless each stockholder surrendered to the banker fifty-one percent of their stock for the purpose of transferring it absolutely to a new manager of the corporation as compensation for his services in attempting to save the business. The Circuit Court of Appeals for the Seventh Circuit, in an opinion by Alschuler, Circuit Judge, held that the surrender of the stock was not voluntary and remanded the case to the Board of Tax Appeals to compute and allow the actual loss sustained by the stockholders.

In *Commissioner of Internal Revenue* v. *Burdick*, 59 F. 2d 395, the Circuit Court of Appeals for the Third Circuit stated the situation as follows:

> "The company fell into financial difficulties so that the need of fresh capital and of new management was felt. A man by the name of Louis C. Kunz was willing to step into the breach upon terms satisfactory to him and decedent. These terms included the furnishing by Kunz of $40,000."

The decedent taxpayer surrendered a large portion of his stock in order to procure new management for the corporation in its financial stress, and the Circuit Court of Appeals for the Third Circuit allowed the resulting loss even though the surrender was voluntary, saying:

> "All he had done was to part with a part and a large part of what he had formerly owned. * * * The real and only consideration he received was the expectation that under the management of Kunz the retained stock of the taxpayer would have an enhanced value."

The reasoning underlying the above conclusion was that one who surrenders value in a crisis in the hope of salvaging a retained interest is entitled to a deduction for the resulting loss if the transaction was in good faith.

In *Deeds* v. *Commissioner of Internal Revenue*, 47 F. 2d 694, the Circuit Court of Appeals for the Sixth Circuit, in considering a similar situation, said:

> "The proper answer to this question depends, we think, upon the purpose and reasonableness of the action taken. It cannot be used as a subterfuge, merely to avoid the payment of taxes, nor as a means of benefaction or bounty; but, if the step be taken in the interest of the taxpayer, in the exercise of an experienced business judgment, and in an effort to avoid even greater and otherwise certain losses, we cannot see that the taxpayer should be precluded from taking the deduction, because the amount of the loss then to be suffered was thus definitely ascertained, and the fact of such partial loss made certain by the action of the taxpayer himself. The facts are none the less clear that, after cancellation, the debts were in fact worthless, were realized to be so by the taxpayer, and were charged off on his books.
>
> * * * * * * *
>
> "This was not the ordinary case of mere forgiveness of indebtedness. It was not a gift. It was the performance of an act which highly experienced and skillful business men honestly believed to be to their own best interests in the avoidance of loss and therefore to the interest of the government in maintaining income. But it nevertheless was an event which definitely and permanently prevented the collection of the debt."
>
> pp. 697, 698.

In the opinion in the present case Allen, Circuit Judge, sought to distinguish the present case from *Deeds* v. *Commissioner, supra,* on the ground that there was no showing in the present case that the debtor was insolvent in the first instance and the debt uncollectible because of such insolvency. It is said that as the owner of 1,308 shares of stock *"in this going concern"* Kennedy, Sr., was not insolvent at the time of this transaction because the collateral had substantial value.

This statement completely overlooks the undisputed fact that O'Bryan Brothers could continue as a going concern only in the event Kennedy, Sr., and O'Bryan Brothers surrendered 751 shares of the collateral. If this had not been done the American National Bank would have withdrawn its guaranty of the corporation's outstanding indebtedness and would have demanded payment of the indebtedness due it, and admittedly the result would have been bankruptcy and liquidation.

At this time the book value of the common stock was approximately $70 per share (see Respondent's Exhibit "A"). The common stock had a value of only $70 or $75 assuming an orderly liquidation (R. 70). It had no market value and there were no sales for a number of years prior to 1932 or 1933 (R. 73, 77, 78). As testified by Kennedy, Jr.:

> "It had absolutely no actual value from the standpoint of sales in 1933. It could not have been sold for any sum. We were operating on what was practically a receivership."
> (R. 69).

Admittedly Kennedy, Sr., was individually insolvent. Unless he and the corporation agreed to surrender 751 shares of the common stock the collateral would have been worth only what might reasonably be expected for the stockholders in bankruptcy. This Court cannot close its eyes to the fact that in June, 1933, at the conclusion of the Bank Holiday, we were in the midst of a world depression and to the further inescapable fact that stockholders would have received absolutely nothing in a bankrupt distribution and it is doubtful whether creditors would have been paid in full. The Board of Tax Appeals and the Circuit Court of Appeals under these circumstances valued the common stock on the basis of its *previous earnings* and concluded that it had an actual value of $150 per share, a conclusion which disregards the

undisputed facts and completely ignores the impending dissolution of the corporation.

The petitioner had to make an immediate decision in a financial crisis. Assuming that it might reasonably have expected to receive as much as $60 per share in liquidation, if it refused to surrender any of its collateral, the total collateral would have yielded $78,480 on the common stock plus $35,000 on the residence, or a total of $113,480, which, deducted from the indebtedness of $208,000, would have left a loss of approximately $95,000. On the other hand, assuming the stock to have a going value of $150 per share, as found by the Board of Tax Appeals, by surrendering 751 shares of the collateral at this value and valuing the 557 shares of stock retained as collateral on the same basis, the petitioner's loss would have been approximately $89,000. In either event no deficiency assessment could be sustained since either loss completely eliminated the profits thereafter fortuitously and unexpectedly resulting from a tornado plus the temporary inflation from the introduction of the N. R. A.

It is therefore respectfully insisted that the court erred in holding that petitioner's act was voluntary and that it contributed to its own loss by such voluntary action. It should also be noted that the Board of Tax Appeals has uniformly held that a surrender of indebtedness or collateral in an effort to save a failing corporation does not prevent the establishment of a deductible loss.

City Builders Finance Co., 21 B. T. A. 800.
Robert Gaylord, Inc., 41 B. T. A. 1119.

In *Robert Gaylord, Inc., supra,* the donation of funds to a failing bank by a local business concern which owned no interest in the bank, made for the purpose of avoiding the economic consequences of a local bank failure, was allowed as an ordinary business expense, the Board of Tax Appeals, in its opinion, saying:

> "If the guaranty had not been raised and the apprehended collapse had occurred, it is entirely pos-

sible that petitioner's business would have been wiped out."

p. 1125.

It is earnestly insisted that the decision of the Circuit Court of Appeals for the Sixth Circuit in the present case is based upon controlling principles which are contrary to those announced by the Seventh Circuit in the Wright case, by the Third Circuit in the Burdick case, and by the Sixth Circuit in the Deeds case, and it is important that this Court take jurisdiction in order to resolve the conflict between these courts. It is also insisted that the question of surrendering collateral through economic necessity and the deduction of consequent losses involves an important question of Federal law which has not been, but should be, settled by this Court.

CONCLUSION.

It is therefore respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers, and that to such an end a writ of certiorari should be granted, and this Court should review the decision of the United States Circuit Court of Appeals for the Sixth Circuit and finally reverse it.

CECIL SIMS,

Attorney for Petitioner.

BASS, BERRY & SIMS,

Of Counsel.

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O'BRYAN BROTHERS, INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 42–46) is reported in 42 B. T. A. 18. The opinion of the Circuit Court of Appeals (R. 88–91) is reported in 127 F. (2d) 645.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 16, 1942 (R. 87). The petition for a writ of certiorari was filed on June 27, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled to an income-tax deduction for a so-called bad debt charged off during the taxable year as not recoverable because it had released a part of the security therefor.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved herein are set forth in the Appendix, *infra,* pp. 10–12.

STATEMENT

This case involves a deficiency in income tax of $11,630.88 and excess profits tax of $1,104.41 claimed from O'Bryan Brothers for the year 1933 (R. 49). The facts may be summarized as follows:

Taxpayer is a Tennessee corporation engaged in the manufacture of work clothes. T. P. Kennedy, Sr., taxpayer's president prior to 1933 and the owner of 1,308 shares of its 1,500 shares of common stock, between 1919 and 1932 withdrew on an open account with the corporation large sums of money aggregating $206,011.51. No notes were given for these withdrawals and no interest was charged on taxpayer's books. (R. 36, 88.) Taxpayer's books showed this amount due at the end of 1933 (R. 37).

At the end of 1931 taxpayer owed the American National Bank of Nashville approximately $145,000 and the bank insisted upon security to

the corporation on account of the indebtedness of Kennedy, Sr., to taxpayer. Kennedy, Sr., accordingly executed a 30-day promissory note for $204,007.56 to taxpayer, and as collateral pledged his entire holding of common stock in the taxpayer corporation and executed and delivered a deed of trust upon certain real property owned by him and appraised at $35,000. The note and collateral were at once assigned to the bank as security for taxpayer's debt to the bank. No attempt was made by taxpayer to collect the note and it was not entered upon taxpayer's books. (R. 37, 88–89.)

In March 1932, the bank assumed management of taxpayer's affairs. Kennedy, Sr. was removed as president and T. P. Kennedy, Jr., formerly one of the vice presidents and manager of production, assumed management of the corporation. In November he was made president at the instance of the bank, which also suggested that he be given 51% of the common stock of taxpayer as an inducement to continue in the management. This was contingent upon taxpayer's consent to release the stock as security. Accordingly, on June 5, 1933, 751 shares of common stock belonging to Kennedy, Sr. were issued to Kennedy, Jr., with the consent of Kennedy, Sr., the bank and taxpayer; taxpayer then wrote down the indebtedness of Kennedy, Sr. to $70,000, charged off

upon its books the balance of $138,567.20 as a bad debt, and claimed a deduction of this amount in its income and excess profits tax return for 1933. (R. 38, 89.)

The disallowance by the Commissioner of Internal Revenue (R. 42) of this deduction was sustained by the Board of Tax Appeals. (R. 44, 89.) The Board's decision was affirmed by the court below. (R. 87, 91.)

ARGUMENT

In the year 1933, taxpayer held a note for $204,007.56 secured by collateral (R. 37). Taxpayer contends that that part of the collateral which consisted of its own shares of stock had declined in value so that the total collateral was worth less than the amount of the debt, and that, accordingly, when it surrendered part of this collateral to the debtor in the year 1933, it was entitled under Section 23 (j) of the Revenue Act of 1932 (*infra,* Appendix) to a deduction for a partially worthless debt, equal to the alleged value of the surrendered collateral (Pet. 4; Br. 9). The Board of Tax Appeals found that the collateral surrendered exceeded the amount of the indebtedness and that no part of the indebtedness was worthless (R. 44). The court below affirmed the Board, holding (R. 89–90) that a taxpayer may not by its own act render a collectible debt uncollectible, charge off the debt as worthless, and

then deduct it from income for purposes of taxation.[1]

The issues were correctly decided and present no questions concerning which there is a conflict of decisions or which warrant further review.

1. Whether or not the debt could have been collected in full at the time of the surrender depends upon the value of the collateral and the financial condition of the debtor. For this reason one of the two issues which the taxpayer asks this Court to review relates to the question of the value per share of the stock which served as collateral. The concurrent findings of the Board of Tax Appeals (R. 44) and the court below (R. 89) that the stock was worth $150 per share, and not, as taxpayer contends, $62.81 per share, are plainly supported by substantial evidence[2] and do not call for further review by this Court.

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[1] The Commissioner contended before the Board of Tax Appeals and the court below that the withdrawals by Kennedy, Sr., were in the nature of dividends and the Board stated that while there may be merit in this contention (See *Lincoln Nat. Bank* v. *Burnet*, 63 F. (2d) 131 (App. D. C.); *Peoples Gin Co., Inc.* v. *Commissioner*, 118 F. (2d) 72 (C. C. A. 5); *Faris* v. *Helvering*, 71 F. (2d) 610 (C. C. A. 9), certiorari denied, 293 U. S. 584) it preferred to dispose of the issue upon the assumption that an indebtedness existed (R. 43).

[2] It is undisputed that taxpayer's earnings amounted to $54.82 a common share (the par value of the stock being $100 a share) without regard to preferred stock and the deduction under consideration; the balance sheets for 1931, 1932, and 1933 indicated that the stock had a book value of $159.27, $166.25, and $128.95 per common share, without

Since the value of the stock must therefore be accepted as being $150 per share, the total value of the 1,308 shares held as collateral security was $196,200. In addition, the debt was secured by certain real estate which had a value of $35,000 (R. 37). Accordingly, the Board's finding that the collateral securing the indebtedness had a value in excess of the debt, which aggregated $206,011.51 (R. 44), is also plainly supported by substantial evidence.

2. The sole remaining issue, therefore, is whether taxpayer, owning a note fully secured by collateral, may, by surrendering part of the collateral to the debtor, claim a deduction for a partially worthless debt. The court below correctly decided that taxpayer could not.

A taxpayer is not entitled to the allowance of a bad debt deduction unless he has made an effort

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attributing any value to the taxpayer's trademark and good will. (R. 36, 44.) In addition, the taxpayer had paid its majority stockholder a salary and bonus of $35,000 per year (in addition to the substantial withdrawals previously mentioned from 1925 through 1930); had paid dividends of 8% on its preferred stock, and dividends of 5% or 10% on its common stock for most of these years. While Kennedy, Jr., president of the corporation, stated that the stock had no market value (R. 44), the Board was not required to accept this testimony (*Dayton P. & L. Co.* v. *Commissioner*, 292 U. S. 290, 298), as opposed to other evidence in the record indicating that the stock had substantial value, particularly in view of the fact that the taxpayer itself valued the stock at approximately $62.81 per share in claiming the deduction (R. 44).

to collect his debt. See Article 191 of Regulations 77. (Appendix, *infra,* p. 10.) A taxpayer may not forgive an indebtedness while his debtor is able to pay, or surrender collateral having value and then claim a deduction. See *Uhl Estate Co.* v. *Commissioner,* 116 F. (2d) 403 (C. C. A. 9); *American Felt Co.* v. *Burnet,* 58 F. (2d) 530 (App. D. C.).

The cases upon which taxpayer relies (Br. 9–11) are not to the contrary. As the court below pointed out (R. 90), the case of *Deeds* v. *Commissioner,* 47 F. (2d) 695 (C. C. A. 6), which the taxpayer cites as conflicting (Br. 11), is distinguishable. There the debtor was insolvent and the debt was uncollectible when the taxpayer surrendered the note to the debtor. The same factor distinguishes *Johnson, Drake & Piper, Inc.* v. *Helvering,* 69 F. (2d) 151 155, 156 (C. C. A. 8), certiorari denied, 292 U. S. 650. Cf. *Stranahan* v. *Commissioner,* 42 F. (2d) 729, 732 (C. C. A. 6), certiorari denied, 283 U. S. 822. And in any event, the taxpayer here did not release Kennedy, Sr. from the debt or any part of it, but rather continued to use the note secured by the rest of the stock as security for its own indebtedness to the bank (R. 37). The taxpayer clearly failed to overcome the Commissioner's determination that the debt was not worthless. See Section 23 (j) of the Revenue Act of 1932, and Article 191 of Treasury Regulations 77 (Appendix, *infra,* p. 19); *Stranahan* v. *Commissioner,*

supra; Higgins v. *Commissioner,* 312 U. S. 212, 218.

But taxpayer urges that a deduction for a bad debt to the extent of the value of the surrendered collateral is allowable in every case where the surrender is involuntary, that is, under economic compulsion, even though the total value of the collateral at the time of the surrender equals the debt (Br. 8–9). The cases cited by taxpayer do not support this contention, but involve other sections of the statute or present differing facts. Thus *Commissioner* v. *Wright,* 47 F. (2d) 871 (C. C. A. 7), involved a loss claimed by a stockholder on the surrender of his stock to the corporation to be paid as compensation to a new manager;[3] the court held that the surrender was not a capital contribution but in effect was a sale of the stock for a valuable consideration, namely, the acquisition of the services of the manager. See *City Builders Finance Co.* v. *Commissioner,* 21 B. T. A. 800. *Commissioner* v. *Burdick,* 59 F. (2d) 395 (C. C. A. 3) (Pet. 5; Br. 10), also involved a loss based upon a sale of most of the taxpayer's stock to another person who furnished money to pay the corporation's debts in connection with a capital reorganization. The case is not applicable here.

In any event there was not an involuntary re-

[3] The bad debt and loss provisions of the statute are mutually exclusive. *Spring City Co.* v. *Commissioner,* 292 U. S. 182, 189, rehearing denied, 292 U. S. 613.

lease in this case. The Board found that the release of the security in connection with the employment of Kennedy, Jr., was subject to the "consent of O'Bryan Brothers," that "All parties to the transaction agreed to the proposition * * *" (R. 38), and that the taxpayer "voluntarily relinquished collateral securing the indebtedness, thereby contributing to the partial worthlessness thereof * * *" (R. 43). It is plain, therefore, that taxpayer voluntarily agreed to the arrangement, which all parties, including taxpayer, considered to be beneficial to taxpayer. There was thus no compulsion, except in the sense that the best interests of the corporation appeared to require the release of the stock.

CONCLUSION

The decision below is correct. There is presented neither an important question of law nor a conflict of decisions. It is, therefore, respectfully submitted that the petition should be denied.

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JULY 1942.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (j) *Bad debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.
>
> * * * * *

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

> ART. 191. *Bad debts.*—Bad debts may be treated in either of two ways—
>
> (1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, or
>
> (2) By a deduction from income of an addition to a reserve for bad debts.
>
> Taxpayers were given an option for 1921 to select either of the methods mentioned for treating such debts. (See article 151, Regulations 62.) The method used in the return for 1921 must be used in returns for subsequent years and in returns under the Revenue Act of 1932 unless permission is granted by the Commissioner to change to

the other method. A taxpayer filing a first return of income may select either of the two methods subject to approval by the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, except as permission may be granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective. (See also article 195.)

Where all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is written down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must

be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. Actual determination of worthlessness in bankruptcy cases is sometimes possible before and at other times only when a settlement in bankruptcy shall have been had. Where a taxpayer ascertained a debt to be worthless and charged it off in one year, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, confirming the conclusion that the debt is worthless, will not authorize shifting the deduction to such later year. If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation.

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